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Tax Treaty Legislation in the 111th Congress: Explanation and Economic Analysis

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Summary

"Treaty shopping" occurs where a foreign parent firm in one country receives its U.S.-source income through an intermediate subsidiary in a third country that is signatory to a tax-reducing treaty with the United States. Supporters of proposals to curb treaty-shopping argue that it would restrict a practice that deprives the United States of tax revenue and that it is unfair to competing U.S. firms. Opponents maintain that proposals to curb treaty-shopping would harm U.S. employment by raising the cost to foreign firms of doing business in the United States and may violate U.S. tax treaties. In addition, some Members of Congress have objected to the use of revenue-raising tax measures under the jurisdiction of tax-writing committees to offset increases in spending programs authorized by other committees.

In the 111th Congress, the America's Affordable Health Choices Act of 2009, H.R. 3200, the Affordable Healthcare for America Act of 2009, H.R. 3962, and the Small Business and the Infrastructure Jobs Tax Act of 2010, H.R. 4849, include tax-treaty proposals which would restrict in certain cases the use of tax-treaty benefits by foreign firms with operations in the United States. The most recent preliminary revenue estimates projected a revenue gain of $3.8 billion over 5 years and $7.7 billion over 10 years, which would be used to partially offset either the cost of health care reform or provide tax relief to small businesses and extend the Build America Bonds. These provision are identical to the provision offered in the Tax Reduction and Reform Act of 2007, H.R. 3970, during the 110th Congress.

Economic theory suggests there is an economically optimal U.S. tax rate for foreign firms that balances tax revenue needs with the benefits that foreign investment produces for the U.S. economy. Under current law, the treaty-shopping arrangements some foreign firms undertake may combine, in some cases, with corporate income-tax deductions to eliminate U.S. tax on portions of their U.S. investment. In these cases, economic theory suggests that added restrictions on treaty-shopping would improve U.S. economic welfare. This analysis, however, does not consider possible reactions by foreign countries where U.S. firms invest, nor does it consider possible abrogation of existing U.S. tax treaties.

This report will be updated as legislative events warrant.

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The chairmen of the three committees with jurisdiction over health policy in the U.S. House of Representatives have introduced the America's Affordable Health Choices Act of 2009, H.R. 3200, and the Affordable Healthcare for America Act of 2009, H.R. 3962, to promote health care reform, and the Small Business and Infrastructure Jobs Tax Act of 2010, H.R. 4849, to provide tax relief to small businesses and extend the Build America Bond program. Among the revenue provisions in all of the acts is one designed to curb "treaty shopping." The most recent preliminary revenue estimates project a revenue gain of $3.8 billion over 5 years and $7.7 billion over 10 years.

Treaty shopping occurs where a foreign parent firm in one country receives its U.S.-source income through an intermediate subsidiary in a third country that is signatory to a tax-reducing treaty with the United States. The purpose of a treaty shopping is solely to reduce U.S. tax liability. Supporters of proposals to curb treaty shopping argue that it would restrict a practice that deprives the United States of tax revenue and that it is unfair to competing U.S. firms. Opponents maintain that proposals to curb treaty shopping would harm U.S. employment by raising the cost to foreign firms of doing business in the United States and may violate U.S. tax treaties. In addition, some Members of Congress have objected to the use of revenue-raising tax measures under the jurisdiction of tax-writing committees to offset increases in spending programs authorized by other committees

The Context: U.S. Taxation of Foreign Firms in the United States

Tax treaty proposals in prior Congresses have been directed at U.S. tax treatment of foreign firms that conduct business in the United States, and to understand how the proposed changes would have affected current law treatment it is useful to take a brief look at the existing structure. A foreign firm that earns business income in the United States is at least potentially subject to two levels of U.S. tax: the corporate income tax and a flat "withholding" tax. The U.S. corporate income tax may apply whether the foreign firm conducts its business through a U.S.-chartered subsidiary corporation or through a branch of the foreign parent that is not separately incorporated. In the case of a U.S. subsidiary, U.S. tax applies because the United States generally taxes all U.S.-chartered corporations, regardless of their ownership; U.S. taxes apply to foreign branch income because the United States asserts the right to tax foreign-chartered corporations on their income from the active conduct of a U.S. trade or business.

In addition, the United States applies a withholding tax on interest, dividends, rents, royalties, and other "fixed or determinable" income foreign corporations and other non-residents receive from sources within the United States.[1] The tax is required to be withheld by the U.S. payer (hence "withholding") and is applied on a "gross" basis without the allowance of deductions. The rate of the tax is nominally 30%. However—and importantly for the proposal at hand—the tax is frequently reduced or eliminated under the terms of one of the many bilateral tax treaties the United States has signed.

In principle, the withholding tax does not apply to intra-firm repatriations of income where a foreign firm's U.S. operation is not separately incorporated in the United States. Since the Tax

[1] The tax is applied by Section 871 of the Internal Revenue Code. Capital gains, however, are generally tax exempt. Also, most "portfolio interest"—that is, interest paid to foreigners whose investment is strictly financial—is exempt from the tax. Interest on intra-firm debt, however, a focus of H.R. 2419 in the 110th Congress, is at least nominally subject to the withholding tax.

Reform Act of 1986 (TRA86; P.L. 99-514), however, the United States has applied a 30% "branch tax" as a parallel to the withholding tax (and that also may be reduced by treaty).

Theoretically, both levels of tax could apply to a foreign firm's U.S. source income. Picture, for example, a foreign firm that operates a U.S.-chartered subsidiary that remits its income to the home-country parent by means of a stream of dividend payments. Dividend payments are not deductible under the corporate income tax, so the tax applies in full to the subsidiary's earnings. Then, if the dividends are paid directly to a parent in a non-treaty country, the 30% withholding tax applies. The combined rate of the two taxes on dividend payments could amount to as much as 53.8%.[2]

This combined rate, however, is usually not reached. First, many types of intra-firm payments are tax-deductible under the corporate income tax, even if the payments are to related foreign parents. For example, interest on intra-firm debt is tax deductible (albeit with some restrictions, as mentioned below); royalties paid for the use of patents, trademarks, and other intangible assets are likewise deductible. Thus, a foreign firm can eliminate the U.S. corporate income tax on income transmitted to its parent via tax-deductible payments. The foreign parent can, for example, finance its U.S. operations by making loans to the U.S. subsidiary; or it can charge the U.S. subsidiary royalty fees for the use of patented technology.

Tax treaties frequently reduce or eliminate the withholding tax. Like most developed countries, the United States is signatory to a large number of bilateral tax treaties. The treaties address a variety of topics aside from withholding taxes—for example, reciprocal assurances of non-discrimination and provisions for the exchange of information by tax authorities. Reciprocal reduction of withholding taxes is, however, a key element of most treaties. To illustrate, the U.S. Internal Revenue Service publication on tax treaties lists tax-treaty withholding tax rates for 56 countries; the top 30% rate applies to intra-firm interest payments in only four instances and is completely eliminated for 20 countries.[3]

In short, notwithstanding the two potential levels of tax, U.S. tax on payments foreign subsidiaries make to their parents can be eliminated or substantially reduced in the case of payments made to firms in a large number of countries. H.R. 3200, H.R. 3962, and H.R. 4849, however, focus on firms whose ultimate home country did not have a tax-reducing treaty with the United States. The next section looks at how such firms are nonetheless able to use "treaty shopping" to reduce or eliminate their U.S. tax.

Treaty Shopping and How it Works

Not all countries have income tax treaties with the United States, so if interest, dividends, royalties, or similar U.S. income were paid directly to firms from these countries, the full 30% withholding tax would apply. "Treaty shopping" is an arrangement where a firm gets around the absence of a treaty by routing its U.S. income through intermediate subsidiary corporations located in third countries where lower or non-existent withholding taxes apply.[4] Treaty shopping,

[2] The corporate tax rate is generally 34%. Since dividends are paid out of after-tax profits, the withholding tax applies at a rate of 30% x (1—34%), or 19.8%. The total rate is thus 34% + 19.8%, or 53.8%.

[3] U.S. Internal Revenue Service, *U.S. Tax Treaties*, Pub. 901, Rev. June 2007 (Washington: 2007), pp. 34-35.

[4] In explaining an anti-treaty-shopping provision of the U.S. model income tax treaty, the U.S. Department of Treasury defined treaty shopping simply as instances where residents of third countries benefit from "what is intended to be a reciprocal agreement between two countries." U.S. Department of the Treasury, Office of Tax Policy, *United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006* (Washington, November 15, 2006), p. 63. The model treaty's anti-treaty-shopping provision is discussed in more detail

further, is not used exclusively by foreign firms conducting business in the United States; it is also used by foreign "portfolio" investors, whose U.S. investments are only financial. However, the focus of H.R. 3200, and H.R. 3962, as described below, on deductible payments, implies that it is targeted to treaty-shopping by foreign corporations, and such is also the focus of this report.[5]

The following countries listed by the U.S. Commerce Department as having significant direct investment in the United States[6] are not on the IRS list of tax-treaty countries:

Argentina	Liberia
Bahamas	Liechtenstein
Bahrain	Malaysia
Bermuda	Panama
Brazil	Lebanon
Chile	Singapore
Gibraltar	Taiwan
Kuwait	Uruguay

Thus, firms whose ultimate home is one of these non-treaty countries are candidates to benefit from treaty shopping. But treaty shopping likely does not occur exclusively in "either/or" situations, where a firm faced by the full 30% withholding tax routes income through a country where no tax applies. Treaty-shopping is likely a matter of degree; a firm facing a 10% rate in its true home country, for example, could benefit substantially from routing U.S. income through a country where no tax applies. Or, a firm facing the 30% rate could benefit by channeling income through an intermediary taxed at only 15%. Further, while the exclusive focus of the current legislative proposals is deductible payments—for example, interest and royalties—treaty shopping can also benefit non-deductible payments such as dividends.

To be attractive as intermediate stops in the treaty-shopping process, a country's treaty provisions must reduce or eliminate the applicable withholding tax rate with the United States, thus reducing U.S. tax on payments to the intermediate subsidiary. In addition, however, the intermediate country must impose no taxes of its own that negate the advantage of a reduced U.S. tax. According to the IRS list, a 0% rate applies to 20 treaty countries in the case of interest payments.

Even if no withholding tax applies to a country, its treaty may contain "limitation on benefits (LOB)" provisions that prevent its use as a conduit for U.S. income. These provisions (also discussed below) have been included in every U.S. treaty that has entered into force since 1990; they have all denied treaty benefits to residents of third countries.[7]

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below.

[5] For a broad discussion of treaty shopping in practice, see Denis A. Kleinfeld and Edward J. Smith, "Limitations on Treaty Shopping," in their *Langer on Practical International Tax Planning* (New York: Practicing Law Institute, 2007), pp. 18-1 - 18:3.9.

[6] U.S. Department of Commerce, Bureau of Economic Analysis, "Foreign Direct Investment in the United States: Detail for Historical-Cost Position and Related Capital and Income Flows, 2002-2006," *Survey of Current Business*, vol. 87, September 2007, p. 69. A "significant" country is defined as having more than $100 million direct investment assets in the United States.

[7] One source lists treaties with the following countries as not containing limitation-on-benefits provisions: Egypt; Greece; Hungary; Korea; Morocco; Norway; Pakistan; the Philippines; Poland; Romania; and Trinidad and Tobago. Jeffrey L. Rubinger, "Tax Planning with U.S. Income Tax Treaties Without LOB Provisions," *Tax Management*

Treaty Shopping Proposals in the 111th Congress

In the 111th Congress, both the America's Affordable Health Choices Act of 2009, H.R. 3200, the Affordable Healthcare for America Act of 2009, H.R. 3962, and the Infrastructure Jobs Tax Act of 2010, H.R. 4849, propose to limit tax treaty benefits with respect to U.S. withholding tax imposed on deductible related-party payments. This proposal is identical to one proposed by H.R. 3970 in the 110th Congress. Under the proposal if a U.S. subsidiary made a deductible payment to a foreign corporation that had a common foreign parent, and the withholding tax rate on the payment would be higher if the payment were made directly to the common parent, the higher rate would have been applied. For example, if the payment were made to a fellow subsidiary in country Y where no U.S. withholding tax applied, and the common parent of the U.S. subsidiary and country-Y subsidiary was a resident in country X where the applicable tax is 15%, the rate that would have been applied to payments to the country-Y subsidiary would be 15%, notwithstanding the nominal 0% rate.

The provision would only apply to payments deductible under the U.S. corporate income tax (e.g., interest and royalties). The degree of common ownership applied by the bill would be 50%. Thus, the provision would apply to payments to a foreign corporation where the U.S. corporation and the payee corporation were linked to a common foreign parent by chains of at least 50% ownership. H.R. 3200, H.R. 3962, and H.R. 4849 all propose that the tax on a payment to a subsidiary could not be reduced unless the withholding tax was also reduced on a direct payment to the parent. Thus, it seems that the acts' restrictions would not apply where a tax-reducing treaty exists with a parent's home country (a treaty the restriction might otherwise violate).

Treaty Shopping Proposals in the 110th Congress

Members in the 110th Congress considered several, largely similar, proposals to curb treaty shopping. All of the proposals would have withheld taxes at the rate of the common foreign parent. The treaty provisions in H.R. 3970 were modeled off of provisions contained in H.R. 2419 and H.R. 3160 with additional language to ensure compliance with existing tax treaties. In all of these proposals, the treaty-shopping provisions would have only applied to payments deductible under the U.S. corporate income tax (e.g., interest and royalties). The degree of common ownership applied by the bills would have been 50%. Thus, the provision would have applied to payments to a foreign corporation where the U.S. corporation and the payee corporation are linked to a common foreign parent by chains of at least 50% ownership.

Pro and Con Arguments

A central concern of supporters of the anti-treaty-shopping proposal is tax revenue: foreign firms that reduce their U.S. withholding taxes with treaty shopping reduce the tax revenue the United States collects on U.S.-source income, and in international taxation, the country of source—in this instance, the United States—traditionally has the primary right to the tax revenue it generates.

International Journal, March 9, 2007, p. 124. Sources engaged in or reporting on the current debate have cited Switzerland and the United Kingdom as being intermediary countries. Respectively: Citizens for Tax Justice, *Senate Should Enact the Doggett Proposal to Close Loophole that Allows Foreign Corporations to Dodge Taxes on U.S. Profits* (Washington: August 8, 2007), posted on the Internet at http://www.ctj.org/pdf/doggettloopholecloser.pdf (visited October 26, 2007); and Eoin Callan, "U.S. Move on Tax Threatens London," *Financial Times*, August 20, 2007, p. 1.

Supporters cite fairness as underlying this concern, contrasting the low U.S. taxes treaty-shopping foreign firms pay with taxes paid by U.S.-resident individuals and businesses.[8]

Opponents of the measure have argued that the provision would increase the cost to U.S. firms of doing business in the United States, and would thus harm U.S. employment and wages.

Alternative Approaches and Previous Legislation

The tax-treaty proposals in the 111th and 110th Congresses were not the first instance where U.S. policymakers have attempted to restrict treaty shopping. Conceptually, one alternative to legislation is to include such restrictions in tax treaties. As described above, the treaties that the United States has negotiated in recent decades have all contained limitation on benefits (LOB) clauses that deny treaty benefits to third-country residents. The LOB provisions generally do so by requiring firms qualifying for a treaty benefit to be owned primarily by residents of the treaty country and not erode the tax base of the treaty country by making deductible payments to third-country residents.[9] The current U.S. model income tax treaty contains such provisions.[10] One analyst has noted, however, that considerable time would be required to renegotiate all U.S. treaties with such an approach, and not all treaty countries would be likely to agree to stringent LOB provisions.[11]

Legislation explicitly restricting treaty shopping was included as part of TRA86's branch tax provisions. Under its terms, a treaty cannot reduce the branch tax for a foreign firm where less than 50% of the firm's stock is owned by residents of the treaty country, or where 50% or more of the firm's income is used to meet liabilities to non-residents.[12] Note that these conditions parallel those of the model income tax treaty.

An existing provision of the tax code that does not directly address treaty shopping, but that is nonetheless related, is the code's "earnings stripping" rules applied by Section 163(j). Earnings stripping refers to the removal by foreign firms of profits earned in the United States by arranging for the subsidiary U.S. corporation to make tax-deductible payments—for example, interest and royalties—to the foreign parent. As described above, such a practice eliminates the U.S. corporate income tax on the deductible payments and, in combination with treaty shopping, can remove all U.S. tax on a foreign firm's U.S. income. Provisions designed to limit earnings stripping by foreign firms investing in the United States were enacted with the Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239) as Section 163(j) of the Internal Revenue Code. The provisions deny deductions for interest payments to related corporations, but apply only after a certain threshold of interest payments and level of debt-finance is exceeded.[13] While the provisions do not address treaty shopping per se, they do address the same general policy goal: attempting to ensure that foreign firms pay some amount of U.S. tax on their U.S. income.

[8] Rep. Lloyd Doggett, remarks in the House, *Congressional Record*, daily edition, vol. 153, July 26, 2007, p. H8683.

[9] Kleinfeld and Smith, "Limitations on Treaty Shopping," p. 18:3.6.

[10] U.S. Dept. of the Treasury, Office of Tax Policy, *United States Model Technical Explanation*, p. 63.

[11] Kleinfeld and Smith, "Limitations on Treaty Shopping," p. 18:3.6.

[12] U.S. Congress, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, committee print, 100th Cong., 1st sess. (Washington: GPO, 1987), p. 1043.

[13] For further information on the earnings stripping provisions, see Aaron A. Rubenstein and Todd Tuckner, "Financing U.S. Investments After the Revenue Reconciliation Act of 1993," *Tax Adviser*, vol. 25, February, 1994, pp. 111-117.

Economic Analysis

Economic analysis of restrictions on treaty shopping begins by focusing on tax revenue: when foreign firms avoid withholding taxes by routing income through treaty-country intermediaries, the United States loses the tax revenue that it would collect if the income were paid directly to a foreign parent and a higher withholding tax were applied. As noted at the outset, the treaty-shopping restrictions proposed in H.R. 3200, H.R. 3962, and H.R. 4849 would increase revenue by an estimated $3.8 billion and $7.7 billion over 5 and 10 years, respectively.

But beyond the proposals' revenue effect, economic analysis poses a more fundamental question: would the plans enhance U.S. economic welfare? The answer to this question still involves the plan's tax revenue impact, but it also looks at a balance—that between the benefit from collecting tax revenue, on the one hand, and from attracting foreign investment to the United States, on the other.

The economic benefit from collecting tax revenue from foreign firms is clear: in collecting revenue, the United States retains in its own economy a portion of the profit that foreign firms would otherwise repatriate to their home country. The counterpoised benefit—the economic benefit from foreign investment—needs a closer look. Popular discussions of foreign investment frequently focus on jobs. But while "inbound" foreign investment can create new employment in particular U.S. geographic areas, its positive impact on the U.S. economy as a whole is on wages rather than jobs, according to economic theory. But, while foreign investment can attract employment from one sector of the economy to another, it does not have an appreciable long-run impact on aggregate employment—a policy goal that is the target of aggregate fiscal and monetary policy rather than targeted tax provisions. Foreign investment can, however, increase wages. Basic economic theory indicates that increases in capital serve to increase labor productivity: foreign investment thus increases productivity of domestic labor. Another basic economic principle holds that, in smoothly functioning markets, labor is paid a wage that is equal to its marginal product. It follows, then, that increases in foreign investment in the domestic economy increase domestic wages.

The balance, then, is this: a given increase in taxes on foreign investors increases tax revenue and produces tax revenue, on the one hand, and a given increase in foreign investment produces higher wages, on the other. But if foreign firms are sensitive at all to taxes, a given tax increase also reduces the U.S. investment they undertake, thus reducing their positive impact on U.S. wages. From an economic point of view, the optimal policy is to tax foreign investors such that the added revenue from an increment of tax is just equal to the reduction in wages that increment would cause. The analogy of a goose and golden egg is perhaps apt.

Is the rate of tax on foreign firms close to the optimal rate? Would the proposals' treaty-shopping restrictions move towards or away from the optimal point? In part, the answer depends on exactly how sensitive foreign firms are to U.S. taxes—the elasticity of supply of foreign investment, in economic parlance. The more sensitive is foreign investment, the lower the optimal tax rate. A thorough investigation of the elasticity of supply is beyond the scope of this report. Importantly, however, in some cases foreign firms may be able to use treaty shopping to eliminate all U.S. tax on their U.S. earnings, and it is unlikely that foreign investors are so sensitive to U.S. taxes that the optimal tax rate on foreign investment is zero.[14] If this is the case, economic theory suggests that it is likely that the proposal would increase U.S. economic welfare.

[14] In economic parlance, an optimal tax rate of zero requires perfectly elastic supply. However, Slemrod, for example,

found a negative relationship between U.S. taxes and inbound investment, but not perfect elasticity. See "Tax Effects on Foreign Direct Investment in the United States: Evidence from a Cross-Country Comparison," in Assaf Razin and Joel Slemrod, eds., *Taxation in the Global Economy* (Chicago: University of Chicago Press), p. 112. Note also that since nominal rather than real interest is tax-deductible, the actual tax burden for debt-financed foreign investment is probably less than zero, which would suggest a less-than-optimal tax burden exists even if foreign investment is perfectly elastic. For a further discussion, see CRS Report 91-582, *Federal Taxes and Foreign Investment in the United States: An Assessment*, by David L. Brumbaugh, August 6, 1991. Copies are available to congressional clients by contacting CRS.

There are, however, a couple of important qualifications. One is economic: the analysis does not take into account possible counter-actions by foreign governments, which might erode or offset any benefit to the United States. For example, a country that is home to firms that would be affected by the treaty-shopping proposals might impose anti-treaty-shopping restrictions of its own that would affect U.S. firms' investment within its own borders. The other is non-economic: as noted above, some have argued that the anti-treaty-shopping proposal in H.R. 2419, from the 110th Congress, would abrogate existing U.S. tax treaties. An analysis of these questions is, however, beyond the scope of this report.

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